THE NECESSITY FOR UNIFORMITY IN STATE AND FEDERAL BANKING LAWS.

IN DELIVERING the opinion of the court in the case of McCulloch *v.* Maryland,[1] Chief Justice Marshall said:

> "The first question made in the cause is—has Congress power to incorporate a bank? It has been truly said that this can scarcely be considered an open question, entirely unprejudiced by the former proceedings of the nation respecting it. The principle now contested was introduced at a very early period of our history, has been recognized by many successive legislatures, and has been acted upon by the judicial department, in cases of peculiar delicacy, as a law of undoubted obligation. * * *
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> "The power now contested was exercised by the first Congress elected under the present Constitution. The bill for incorporating the Bank of the United States did not steal upon an unsuspecting legislature and pass unobserved. Its principle was completely understood, and was opposed with equal zeal and ability. After being resisted, first in the fair and open field of debate and afterwards in the executive cabinet, with as much persevering talent as any measure has ever experienced, and being supported by arguments which convinced minds as pure and as intelligent as this country can boast, it became a law."

The decision in this case which was rendered by the Supreme Court of the United States nearly 100 years ago and which has been repeatedly affirmed since that time,[2] effectively disposes of the contention that the right to create banks and to legislate

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[1] 17 U. S. 316, 401.

[2] Osborn *v.* U. S. Bank, 22 U. S. 737; Slaughterhouse Cases, 83 U. S. 36, 64; Legal Tender Cases, 110 U. S. 421, 445; Luxton *v.* North River Bridge Co., 153 U. S. 525, 529; Christopher *v.* Norvell, 201 U. S. 216, 226; Wilson *v.* Shaw, 204 U. S. 24, 34; Robinson *v.* Turrentine, 56 Fed. 554, 555; Dolley *v.* Abilene Nat. Bank, 179 Fed. 461, 465; Larabee *v.* Dolley, 175 Fed. 365, 392; Veazie Bank *v.* Fenno, 8 Wall. 533, 551; Mercantile Trust Co. *v.* Texas and P. Ry. Co., 216 Fed. 225, 231; Easton *v.* Iowa, 188 U. S. 220, 229; Farmers National Bank *v.* Dearing, 91 U. S. 29.

on the subject of banking belongs exclusively to the states. The federal government has from time to time exercised this right, but until recent years there has been a lack of co-operation as between the states and the federal government in the matter of banking legislation and a lack of uniformity in the banking laws of the several states.

For many years banks were chartered by special acts of the legislature. In defining the corporate powers of some of the earlier state banks certain restrictions were imposed upon their operations. These restrictions related primarily to the amount of indebtedness that might be contracted and to the character of investments to be made.

As a later development banks were chartered under the general corporation laws of the state. The charters granted under these laws lacked uniformity, were very broad in their scope, and in most instances were free from restrictions.

It is only in recent years that the states have adopted general laws regulating the business engaged in by banks, and it was not until 1863 that the federal government attempted to create a banking system by the passage of what is now known as the National Bank Act.

It is in the adoption of these general laws defining and regulating the business of banking that uniformity and co-operation are so essential. If the federal government and the forty-eight states act independently of each other, it necessarily follows that the business of the country must be conducted under forty-nine banking systems which may differ in many important essentials. It is a significant fact that the restrictions imposed upon the operations of the earlier state banks, when legislative charters were granted, were designated primarily to safeguard the credit of these banks. Even at that early period of our national history, the fact appears to have been recognized that bank credit would be used extensively as a medium of exchange in commercial transactions, and it was, therefore, necessary to restrict the amount of obligations to be assumed by corporations engaged in the banking business and to define the character of investments to be made. The enormous development of the commercial business in the United States since that time and the extent that

bank credit is now used as a medium of exchange makes it of prime importance that there should be adopted standard "rules of action" or laws regulating the banking business, since regulation and supervision under any system have an important bearing upon the value of the credit of the banks composing the system.

In so far as a bank's business is local, the reputation of those who have charge of its management may be a sufficient guarantee of its credit, but when a bank engages in transactions with those who have no personal knowledge of its management reliance must be placed upon its statement of condition rather than upon the personnel of its board of directors, and the reliability of this statement must depend to a very great extent upon the character of the laws under which it operates and the manner in which such laws are administered. It is not sufficient that its statement shows an excess of assets over liabilities due to creditors, but the investment of its funds must have been made under laws which provide for proper regulation and supervision of its business.

There are few industries which confine their operations to the borders of the state in which they are domiciled, and while a bank may receive its deposits and make its loans more or less locally it is required as an incident of its business to transfer funds from one state to another for the benefit of its customers and must have relations with correspondent banks in other states. It must in these relations become both the debtor and the creditor of its correspondents. The value of its credit is, therefore, a matter of interest to those outside of the borders of its state and it has a reciprocal interest in the value of the credit of banking institutions located elsewhere.

A review of the history of banking legislation and particularly of the circumstances under which state bank notes were withdrawn from circulation illustrates the necessity for the adoption of standard banking laws in order that bank credit may be stabilized. In their inception both state and national banks performed the functions of banks of issue as well as banks of deposit and discount. Before the Civil War state bank notes constituted one of the principal mediums of exchange. Under

existing laws while state banks still have the legal right to issue bank notes, only national banks and the recently created federal reserve banks exercise this right. State bank notes are no longer in circulation. The fact that Congress imposed a prohibitive tax on state bank circulation was due in part at least to the lack of uniformity in state banking laws and seems to have grown out of the fact that the rivalry between state and federal banks resulted in a consistent effort on the part of the advocates of state banks to prevent the establishment of a national system rather than to perfect a system under the state laws.

The Bank of North America, which is generally conceded to be the first incorporated banking association in the United States, was chartered by the Continental Congress in 1781. The question was immediately raised whether the federal government had the power to create a banking corporation and in view of the doubt which then existed on this subject, another charter was procured in 1782 under the laws of Pennsylvania. The right of the federal government to incorporate a bank was again brought into question about ten years later when the first Bank of the United States was proposed. Its establishment was bitterly opposed on the ground that Congress was without any express power under the Constitution to charter a bank. Alexander Hamilton, the first Secretary of the Treasury, contended that, while this power was not expressed in the Constitution, it was clearly implied as an incident to other powers granted, and he succeeded in convincing Congress and the President of the soundness of his position. In 1791 a charter was granted for a period of twenty years and upon its expiration in 1811, the eighty-eight state banks then in existence bitterly opposed its renewal and by uniting with the political enemies of Albert Gallatin, the Secretary of the Treasury at that time, they succeeded in defeating the bill for its renewal by one vote.

In 1814 Dallas, who succeeded Gallatin as Secretary of the Treasury strongly advocated the establishment of another bank under federal law, but it was not until 1816 that the second bank of the United States was chartered for a period of twenty years. The right of Congress to incorporate this bank was also bitterly contested, and it was in sustaining this right that Chief Justice

Marshall delivered the opinion of the court in the case of McCulloch *v.* Maryland. This bank obtained a charter from the state of Pennsylvania before the expiration of its federal charter, but was finally forced out of existence through political influence in 1841.[3] From 1841 to 1863 the banking business in the United States was conducted exclusively by banks created under state laws. The bank note which represented the credit responsibility of the issuing bank was the accepted medium of exchange, and its circulation necessarily extended beyond the borders of the state in which the issuing bank was located.

It may be said to be an elementary principle of economics that any substitute for specie currency must have a stable value if it is to be used successfully as a medium of exchange. If a credit instrument is to be used to discharge other obligations its value must be unquestioned. Accordingly, if a bank note is to be accepted in discharge of an individual liability, the individual accepting the bank note must be assured that at his option it can be converted into specie at its face value. Some of the states realized this and imposed the necessary restrictions on the issue of such notes. Banks were required to maintain a proper reserve of cash against them to make provision for their prompt redemption and the amount of issue was limited by the laws of the state. Others imposed few if any safeguards. Little or no provision was made for their redemption and the value of the note as a medium of exchange depended upon the reputation of the issuing bank. The inevitable result was that the notes of some banks were accepted at par through a wide section of the country. The notes of others were accepted at par in the immediate neighborhood of the issuing bank, but were discounted when offered in settlement of liabilities in other parts of the country. The notes of still other state banks had little or no value as a medium of exchange. As the states had failed to standardize their banking laws it became necessary for the federal government to pass an act designed, among other things, to provide for a more uniform currency, and to accomplish in

[3] For history of first and second banks of the United States, see Holdsworth, First Bank of the United States (Nat. Mon. Com.) and Holdsworth, Money and Banking, 129ff.

this way what the states had failed to accomplish by not adopting uniform laws on this subject.

The Act of 1863 was known as an act to provide a national currency secured by a pledge of United States stocks and to provide for the circulation and redemption thereof. In 1874 its title was changed to "The National Bank Act." As originally passed this act provided that banks obtaining federal charters either by conversion from state banks or otherwise might issue notes secured by United States Government bonds, deposited with the Treasurer of the United States. National banks were permitted to issue their notes to the extent of ninety per cent of the bonds deposited.[4] State banks were likewise permitted to issue notes secured by government bonds to the extent of eighty per cent of the bonds deposited.[5]

As a result of the old rivalry between state and federal banks, few state banks were converted and comparatively few national banks were organized. The following year, in 1864, Congress determined that the original act was defective in many particulars and so amended and re-enacted it omitting many of its original provisions. One of the provisions omitted was that state banks might issue circulating notes on the security of government bonds. In order still further to standardize bank notes as a medium of exchange, Congress passed an act in 1875 reading in part as follows:

> "That every person, firm, or association, other than national banking associations, and every corporation, state bank, or state banking association shall pay a tax of ten *per centum* on the amount of their own notes used for circulation and paid out by them. * * * That every such person, firm, association, corporation, state bank, or state banking association, and also every national banking association, shall pay a like tax of ten *per centum* on the amount of notes of any person, firm, association other than a national banking association, or of any corporation, state bank, or state banking association, or of any town, city, or municipal corporation, used for circulation and paid out by them." [6]

[4] Act of Feb. 25, 1863 (U. S.).

[5] Act of Feb. 25, 1863 (U. S.), § 62.

[6] Act of Feb. 8, 1875 (U. S.), c. 36, §§ 19 and 20; 18 Stat. at L. 311.

It is a matter of historical interest that in 1777 the State of Virginia passed an act to protect circulation somewhat similar to the above. This act provided that:

> "WHEREAS, divers persons have presumed upon their own private security to issue bills of credit or notes payable to the bearer in the nature of paper currency, a penalty is imposed upon those who issue or offer in payment any such notes without authorization of the Commonwealth, of ten times the amount of the note, half to go to the informer." [7]

The right of Congress to impose a tax on state bank circulation was contested and in sustaining this act the Supreme Court of the United States said in Veazie *v.* Fenno: [8]

> "Having thus, in the exercise of undisputed constitutional powers, undertaken to provide a currency for the whole country, it cannot be questioned that Congress may constitutionally secure the benefit of it to the people by appropriate legislation. To this end Congress has denied a quality of legal tender to foreign coins, and has provided by law against the imposition of counterfeit and base coin on the community. To the same end Congress may restrain by suitable enactment the circulation as money of any notes not issued under its own authority. Without this power, indeed, its attempts to secure a sound and uniform currency for the country must be futile."

It was argued in this case that the act was unconstitutional because the amount of the tax indicated a purpose on the part of Congress to destroy a franchise of the state banks. The court in discussing this point said:

> "It is insisted, however, that the tax in the case before us is excessive, and so excessive as to indicate a purpose on the part of Congress to destroy the franchise of the bank, and is therefore beyond the constitutional power of Congress.
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> "The first answer to this is that the judicial cannot prescribe to the legislative departments of the government limitations upon the exercise of its acknowledged powers. The power to tax may be exercised oppressively upon per-

[7] See A History of Banking in all Nations, Journal of Commerce and Commercial Bulletin, 11; 9 Henning, Statutes at Large (Va.), 431.

[8] 8 Wall. 533, 549.

sons, but the responsibility of the legislature is not to the courts, but to the people by whom its members are elected. So, if a particular tax bears heavily upon a corporation, or a class of corporations, it cannot, for that reason only, be pronounced contrary to the Constitution." [9]

While Congress would no doubt have created the national banking system in any event, since it became necessary for the government to have these agencies to assist in the conduct of its fiscal affairs, and particularly to aid in the sale of its bonds, it is at least probable that, except for the lack of security required as a condition of issue of the state bank notes and the lack of proper laws regulating their redemption, such notes would have been permitted to remain in circulation.

Since 1864 the number of banking institutions in the United States has increased at a very rapid rate. According to the report of the Comptroller of the Currency for the year 1915, there are now in existence more than 7,500 national banks and approximately 18,000 commercial banking corporations organized under state laws. While the corporate powers of the several state banks vary, the functions of those banks which engage in a commercial banking business are substantially similar to the functions of national banks, except that state banks no longer issue their notes. Bank credit in another form, however, is still used as a medium of exchange in commercial transactions and the same necessity exists for uniform bank supervision and for the adoption of standard banking laws designed to stabilize bank credits that existed when the national banking system was created.

In speaking of the functions of a commercial bank, Mr. Holdsworth, Dean of the School of Economics of the University of Pittsburgh, in his recent work on Money and Banking, says:

"A bank has been aptly defined as a manufactory of credit and a machine for facilitating exchanges. It manufactures credit by accepting the business prospects of its customers as security in exchange for its own bank credit in the form of a deposit account. Business credit cannot be conveniently used for current business transactions, but bank credit in

[9] 8 Wall. 533, 548.

> the form of checks and drafts is widely acceptable and is the actual medium of exchange for a large part of the community." [10]

Mr. Brown, Instructor in Political Economy in Yale University, in his work on International Trade and Exchange, says that it is estimated that more than nine-tenths of the total business of the United States is carried on through the use of bank credit.[11] While this bank credit now takes the form of checks or drafts which to a certain extent take the place of bank notes, the stability of such credit as a medium of exchange must depend primarily upon the financial responsibility of the banks. This responsibility should be insured by a strict regulation and supervision of the several thousand banks which compose our banking system. In recent years many if not most of the states have adopted laws designed to safeguard the banking business, and have recognized the necessity for uniformity by the adoption in forty-four of the forty-eight states of the Union of the Negotiable Instruments Law. If our banking system, however, is to reach its greatest efficiency, it is necessary that there should be a still more extensive co-ordination of banking powers and a more nearly uniform system of supervision and regulation.

The commercial banking business in so far as it is defined by Congress and by the laws of some of the states may be said to comprise the right to discount and negotiate promissory notes, drafts, bills of exchange, and other evidences of debt; to receive deposits; to buy and sell exchange, coin, and bullion; to lend money on personal security and otherwise;[12] and in the case of national banks to place in circulation bank notes secured by United States Government bonds. If it is conceded, as it must be, that corporations, which are permitted to receive on deposit funds of others and to invest such funds, should be restricted in the character of investments to be made and in the use of the funds so received, and that all proper safeguards should be provided for, it is clear that some standard should be adopted in the

[10] Holdsworth, Money and Banking, 149.

[11] Brown, International Trade & Exchange, 29 (New York, McMillan & Co., 1914); Fisher, The Purchasing Power of Money, 317, 318 (New York, McMillan & Co., 1911).

[12] Revised Statutes of U. S., § 5136.

matter of regulation and supervision of the banking business which will best accomplish this purpose. An examination of the state laws, however, shows a wide diversity of opinion on this subject.

For example, the capital stock and surplus of banks which represents the excess of assets over liabilities due to creditors is subject to varying requirements in the different states. In some states a minimum is required ranging from ten to twenty-five thousand dollars; in others no minimum is fixed by law. Some of the states, as an additional security to the depositor and customer of the bank, provide for double liability of the stockholders, but in a large number of the states this provision is omitted from the statutes.

In the matter of examination and supervision, while the general tendency is to establish distinctive banking departments and to provide for adequate examiners, this work is still performed by other commissions and state officers in several of the states. The form of report of condition used by the several states likewise lacks uniformity, and the number of reports required varies. The reserve or cash on hand to be retained in order to meet current liabilities and to provide for emergencies varies from ten to twenty-five per cent of the demand liabilities of the banks in the several states. In some states the individual borrower's liability is limited to a percentage of the capital stock of the lending bank. This percentage varies from ten to thirty per cent. In many instances banks are forbidden to make loans on or to purchase their own stock; while in others this provision is not incorporated in the state laws regulating the banking business.[13] In recent years a great many of the states have enacted provisions substantially similar to those contained in the National Bank Act, but there is still a lack of uniformity in many important details.

It cannot be denied that there still exists a certain degree of rivalry as between state and national banks and that the advantages to be derived from greater co-operation are not fully appreciated and understood. This rivalry may be desirable as

[13] For analysis of state laws, see National Monetary Commission, Vol. 3.

between individual banks in so far as it tends by legitimate competition to strengthen the banks, but where it takes the form of opposition to proper development of the national system or of any state system it operates to the disadvantages of both state and national banks.

If banks organized under federal law offer no greater security to the depositor and enjoy no wider field of activity than those organized under state laws, the state banks have no more to fear from their national bank competitors than from other state institutions. If the federal laws impose more careful safeguards and restrictions on the business of banking and if national banks are more carefully supervised and managed than state banks, it would seem to be obvious that the remedy is not a curtailment of national banking powers but the adoption of some standard of banking laws designed to insure to the depositor and customer of the bank the proper degree of safety and conservatism in management. The fallacy of contesting the right of the federal government to exercise its sovereign power to create banking corporations has been abundantly demonstrated, and it should be manifest that the best interests of the government, the banks, and the public will be served by perfecting a compact system of banking under which it will be immaterial whether the bank's operations are conducted under federal laws or the laws of any one of the several states.

The development of our trade relations with other countries makes it of additional importance that the bank credits of this country should be stabilized as far as possible by the perfection of a compact system of banking under which the banks composing the system may operate under laws which provide for necessary regulation and supervision.

As a result of the European war many neutral countries have been deprived of the financial assistance extended them by England, Germany, and the other countries now at war, and the United States is called upon to assist in financing their commercial transactions.

In order to do this bank credit will be utilized to an even greater extent than it has been in the past and it may reasonably be expected that the banker's acceptance will come into more

general use as our foreign trade develops. The bank by becoming an acceptor of a draft or bill of exchange lends its credit or its potential ability to borrow money rather than its funds. A liability is assumed under circumstances which differ in many respects from that which is created by giving credit to a borrower in the form of a deposit balance.

By way of illustration, let us assume that an importer in Boston has agreed to purchase goods from a dealer in South America. The dealer has agreed that the purchase price is not to be paid until ninety days after the goods reach Boston but in the meantime he desires to borrow the amount of the purchase price on the strength of the importer's obligation to him.

According to the custom usually followed in this country the importer would execute his promissory note for the purchase price payable to the dealer ninety days after date and the note might be discounted with the dealer's endorsement or the dealer might draw a draft or bill of exchange on the importer payable ninety days after sight and the importer might accept this draft and discount it at his bank remitting the funds to the dealer in South America.

In both instances the importer would become primarily liable on this obligation either as the maker of the note or as the acceptor of the draft and the dealer would become secondarily liable as endorser of the note or drawer of the draft or bill of exchange.

In either case the bank would ordinarily credit the proceeds of the discount to the deposit account of the borrower instead of paying him in gold or legal tender. By this operation the borrower is given the right to draw against the bank which may be said to have loaned its credit or responsibility in exchange for that of the borrower.

Following the custom extensively used in other countries, however, the bank by becoming the acceptor may lend its credit in another form to the importer in order to enable him to obtain funds elsewhere. That is to say, the importer may arrange with the bank under a proper guarantee to permit the dealer to draw on the bank rather than on himself. The bank may accept this draft thus becoming primarily liable and this

acceptance may then be discounted or sold elsewhere. In this way the bank by lending its credit has enabled the importer to make remittance to the dealer in South America; to procure the goods, convert them into a finished product, and sell them. Out of the proceeds of the sale of the finished product the dealer can then furnish the bank with funds with which to pay the acceptance when it matures.

Prior to the passage of the Federal Reserve Act national banks were not permitted to accept drafts or bills of exchange under the circumstances recited. They are now permitted to execute such acceptances to a limited extent when the transaction, as in this case, is based upon the importation or exportation of goods.[14] Under some state laws banks have been permitted for sometime past to execute such acceptance but while this is an older form of obligation under the law merchant than the promissory note, the negotiable note is much more extensively used under our system of banking.

A domestic bank acceptance, that is, an acceptance executed by a bank in a transaction which does not involve the importation or exportation of goods, is used still less in this country and national banks are not authorized to lend their credit in this way although they may discount or purchase domestic acceptance of others.

It will be readily seen that as this form of bank obligation comes into more general use there will be an additional necessity for the adoption of laws designed to stabilize bank credits. These bank credits or acceptances will in due course be offered for sale in other countries since they involve both export and import transactions, and the dealers in other countries will in many cases desire to use the funds to be realized from the sale of such acceptances elsewhere than in the United States.

The safeguards adopted by the several states, and by the federal government, and the laws regulating the use of bank credits, will necessarily have an important bearing on the value of such credits. Few banks will be able to establish an international reputation which will enable their acceptances to be sold in other countries except at a material discount. If, however, the proper

[14] Federal Reserve Act, § 13.

safeguards are adopted by Congress and the various state legislatures there will gradually develop a market for acceptance of banks operating under the laws of the United States and of the several states.

The outlook for the perfection of a compact banking system is more encouraging at this than at any previous time in the history of this country. Due in part at least to the influence of the several bankers association there has developed in recent years a decided tendency on the part of the state authorities to co-operate both in the matter of legislation and in the administration of banking laws. From a practical standpoint standardization should logically come through the federal government not by a curtailment of state banking powers but by offering a medium for the co-ordination of the powers of state and national banks.

The Federal Reserve Act is intended, among other things, to accomplish this purpose. Under this act state as well as national banks are offered the advantages of the Federal Reserve System. State banks becoming members will be enabled to obtain funds by rediscount of eligible paper; they will receive the advantages to be derived from a system of clearances through federal reserve banks, will be subject to proper regulation and supervision as member banks and will form a constituent part of a co-ordinated and co-operative system. They will be left free to conduct their ordinary operation in their own way subject only to such general regulations and restrictions as are clearly necessary to safeguard the interests of the public, the government and the banks.

In order to become members of the Federal Reserve System it is necessary for state banks and trust companies to subscribe to and hold stock in a federal reserve bank. Under the laws of some of the states banks are prohibited from holding stock in other corporations. In many instances this obstacle to membership has been removed by amendments to the state laws.

For the purpose of vesting in national banks power exercised by many state banks and trust companies, the Federal Reserve Act provides that under certain circumstances national banks, with the approval of the Federal Reserve Board, may act as

trustee, executor, administrator and registrar of stocks and bonds where the exercise of these fiduciary powers does not contravene the laws of the state in which the bank is located.[15] Many of the states have given their sanction to this attempt on the part of Congress to co-ordinate state and national banking powers by passing enabling acts for the purpose of removing any question of conflict with the state laws.

In addition to these evidences of co-operation, there is every indication that those charged with the administration of banking laws are working in complete harmony with the view of standardizing as far as possible the supervision of the banks. The prospects are, therefore, unusually favorable and encouraging for the development of a scientifically sound system of banking which will contribute materially to the development and prosperity of the country as a whole.

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[15] Federal Reserve Act, § 11 (k).